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# Sovereign wealth funds and ethical investment guidelines: the role of regime type

## Report

# Sovereign Wealth Funds and Ethical Investment Guidelines: The Role of Regime Type[1]

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**Abstract**

*In the popular discourse it has often been implied that SWF investments from non-Western economies with low democracy levels are driven by political imperatives. If that is true then how can we explain that SWFs from Western democratic countries adopt ethical investment guidelines, which are often linked to politics? In order to explain that the present article takes a comparative approach by looking at regime types, domestic debates and the sequences in which ethical investment guidelines were adopted across SWFs. Therefore it looks at 10 of the most transparent SWFs. High levels of transparency allows for close scrutiny and monitoring of the SWFs investment practices, specifically by a country's population. However, the rule set governing the interactions between the government and population can vary significantly across countries. Based on the case study findings this article is able to formulate an initial hypothesis: SWFs of countries with parliamentary systems and high levels of political freedom are more likely to adopt ethical investment guidelines.*

**Acronyms: sovereign wealth funds, political freedom, transparency, parliamentary system, presidential system, ethical investment guidelines.**

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INTRODCUTION

A major concern amongst observers has been the underlying investment motives of SWFs in terms of whether they are driven by an economic or political rationale. The combination of size and 'novelty' has led commentators to describe SWFs as potential sources of stability or instability in the international economy.[2] While there are those, most notably Summers (Summers *quoted* in *The Financial Times,* 30 July 2007) who argue that SWF investments might be politically motivated and therefore destabilising, others, such as Srinivasan (2008), highlight the stabilising effect of long-term investments made by SWFs.

The present article treats the adaptation of ethical investment guidelines – taking account of environmental and social factors in the investment decision process – as a political rationale. It is worth highlighting that the present article treats ethical investment guidelines neither as a normative category (i.e. in terms of whether an investment is good or bad) nor in terms of business ethics (i.e. in terms of pursuing legal business practices and preventing improper business practices such as money laundering and protecting intellectual property rights).

A key mechanism to implement ethical investment principles relates to the 'negative screening' and the exclusion of some companies/countries/sectors on specified ethical reasons such as environmental, human rights and labour rights. The adoption of ethical investment guidelines has consequences. For example, an investor that adopts ethical guidelines through exclusion of sectors and companies limits its universe of investment opportunities, which also might have an effect on diversification attempts and return prospects. A commentator's statement that "[d]ivestment is a moral gesture, but financially, all it achieves is to make stocks cheaper for other investors with fewer scruples" suggests that ethical investors achieve only inferior return as compared to investors without ethical investment guidelines (*The Financial Times*, 29 May 2015).[3]

This article explores how and why regime types affect choices concerning the adoption of ethical investment guidelines. Therefore it looks at similar and different adoptions of ethical investment guidelines among SWFs with high levels of transparency that are located in different political systems. That helps to assess the different impacts of parliamentary and presidential systems on different adaptation of ethical investment guidelines among SWFs.

This paper finds that SWFs of countries with low political freedom scores are less likely to adopt ethical principles that guide their investments. That is because the political structures in place provide the SWF governance structure with more insulation from public opinion and from the values of their citizens. In line with this observation this article finds that countries with high levels of political freedom are more likely to have SWF with explicated ethical investment guidelines. Here governments and the political system in place giving greater affect to the values of their citizens through the SWFs investment policies. The findings confirm Clark and Monk's observation that transparency combined with high levels of political freedom allows close scrutiny of SWF investments and the expression of dissatisfaction among a country's population with regard to SWF investments (see Clark and Monk,

[2] Within the SWF literature it is widely agreed that SWFs have been in existence at least since the 1950s.
[3] Commentators in the financial press, notably representatives from *The Financial Times*, are sceptical in terms of whether funds with ethical investment guidelines outperform broader stock market indices (*The Financial Times,* 20 Feb 2015).

2009). In addition to that, the present article also adds an institutional dimension in terms of regime type effect.

However, fine-grained differences exist between parliamentary and presidential systems with high levels of political freedom. While SWFs of countries with presidential systems tend to have no ethical investment guidelines in place, SWFs of countries with parliamentary systems tend to have ethical investment principles. In turn this reflects aspects that relate to the insulation of SWF governance. In parliamentary systems governments can be dissolved at any time and the Minister of Finance are selected from the elected legislature, whereas in a presidential system the government is in office for a fixed term and the Minister of Finance is appointed by the President.

**Section 1** looks at 10 of the most transparent SWFs. It investigates whether SWFs similar in terms of transparency and their official mandate adopt different guidelines in terms of ethical investment. This helps evaluating whether there is variation in terms of 'adoption of ethical investment guidelines' that is not systematically related to mandate and funding source.

**Section 2** looks at SWFs from countries that have adopted ethical guidelines (i.e. Norway, Australia, New Zealand, Ireland), whereas **Section 3** looks at SWFs from countries that have not adopted ethical investment guidelines (i.e. Chile, Alaska, Singapore, Azerbaijan, Malaysia, UAE). Each of the chapters outlines the characteristics of political systems and establishes a relationship between ethical guidelines and regime type. They investigate whether countries with similar regime types make similar choices with regard to SWFs in terms of whether to adopt ethical investment guidelines. Thereby the chapters make a contribution to the study of state finance institutions by developing initial hypotheses on the effects of regime type on investment behavior of SWFs.

### 1. The Puzzle of SWFs with ethical investment guidelines

Despite similarities in their official mandates, funding sources and transparency levels SWFs adopt different approaches with regard to ethical investment guidelines. For example, out of the 10 most transparent SWFs we can observe differences between OECD and non-OECD economies (see Table 1). While SWFs of Norway and New Zealand have adopted explicit ethical guidelines, SWFs of Malaysia, Azerbaijan have not integrated explicit ethical guidelines in their investment framework. However, variation in terms of the adoption of ethical investment guidelines exists not only between SWFs of non-OECD and OECD countries but also within the latter group. For example, a number of SWFs from OECD countries notably Alaska/US and Chile have not adopted ethical investment guidelines. Furthermore, no systematic variation in terms of ethic investment guidelines exists that can be attributed to funding source and the official mandate. For example, both Alaska as well as Norway have oil funded SWFs with a stabilisation and future savings mandates but both SWF differ in terms of whether they have adopted ethical investment guidelines.

*Table 1, Most transparent SWFs and the specification of ethical investment guidelines*

| **SWF name** | **Country** | **Size US$ bn** | **Funding Source** | **Transparency Ranking** | **Mandate** | **Ethical guidelines specified** |
|---|---|---|---|---|---|---|
| Government Pension Fund | Norway | 824,9 | Commodity | 10 | Stabilisation Future generations | **Yes** |
| Permanent Fund | US-Alaska | 53.9 | Commodity | 10 | Stabilisation Future generations | **No** |
| New Zealand Superannuation Fund | New Zealand | 20.2 | Non-commodity | 10 | Future generations | **Yes** |
| National Pension Reserve Fund | Ireland | 23.5 | Non-commodity | 10 | Future generations | **Yes** |
| Future Fund | Australia | 95 | Non-commodity | 10 | Future generations | **Yes** |
| Temasek | Singapore | 193.6 | Non-commodity | 10 | Development | **No** |
| Mubadala | United Arab Emirates | 66.3 | Commodity | 10 | Development | **No** |
| State Oil Fund | Azerbaijan | 37.3 | Commodity | 10 | Development Stabilisation | **No** |
| Social and Economic Stabilization Fund | Chile | 15.2 | Commodity | 10 | Stabilisation Future generations | **No** |
| Khazanah Nasional | Malaysia | 41.6 | Non-commodity | 9 | Development | **No** |

**Sources:** SWF Institute 2015, individual SWF reports and SWF websites.

Addressing the puzzle of differences in the adaptation of ethical investment guidelines across SWFs the following chapters focus on the underlying variation in regime type and political freedom. It is useful to look at each SWF individually, and see whether variation in the adaptation of ethical investment guidelines can be systematically related to regime type of a country and the levels of political freedom.

## 2. SWFs with ethical investment frameworks

*The Norwegian Pension Fund Global and the turn to ethics*

The Norwegian Pension Fund Global (NPFG) is the world's largest SWF. As of 2015 its assets under management are estimated at around US$ 900 bn. The NPFG funding source relates to oil and gas revenues. Norway's government put a tax levy of 78 % on oil and gas production and other taxes and dividends from Norway's state owned energy company Statoil (*The Financial Times*, 3Nov 2014). The NPFG's purpose is to support the financing of Norway's National Insurance Scheme. As such it addresses long-term considerations in the spending of government petroleum revenues.

The NPFG has one of the highest scores in transparency and follows ethical investment guidelines. It has published a set of general voting guidelines and information about the management of its ownership rights. As of 2015 the NPFG's ethical criteria are based on the UN Global Compact, the OECD Guidelines on Corporate Governance and the OECD Guidelines for Multinational Enterprises. The NPFG's investments are electronically available and comprise more than 8000 companies (Bakker, 2014). As such, the NPFG owns on average 1.25% of every listed company in the world (*The Financial Times,* 8 August 2013).

At the beginning, in the 1990s, the NPFG did not have ethical investment guidelines. Tranøy's statement that "[i]nitially the Central Bank was prone to ridicule the idea, and made it appear as the pipedream of 'irresponsible' left-leaning social democrats" suggests initial scepticism towards the adoption of ethical guidelines (Tranøy, 2010, p.191). Although discussions about the adoption of ethical principles started soon after the NPFG's creation, it was in the 2000s when an ethical investment framework was adopted (Tranøy, 2010). That was in the context of regular reporting on the NPFG investments, such as in the production of land mines and in child labour (Tranøy, 2010). Extensive media coverage on the NPFG's investments in the multinational TOTAL, which at that time had close links to the Burmese military regime, put significant political pressure to exclude TOTAL from the NPFG (Chesterman 2008). The Norwegian Finance Minister became increasingly exposed to public criticism (Chesterman 2008). Consequently, the Norwegian government established an ethical council to deal with the issue of controversial investments (Chesterman 2008).

The creation of the ethical council was a 'defensive measure' in order 'to pacify a domestic constituency' (Tranøy, 2010, p.178). According to Tranøy (2010) the council deflects claims against the Minister of Finance and thereby insulates the Minister against critique. This committee was created in 2002 and was headed by a legal scholar and philosopher without background in finance (Tranøy, 2010). The council of ethics makes assessment of cases and advises the Ministry of Finance. More recently environmental groups together with the Labour opposition started a debate lobbying about disinvestment from fossil fuels and environmental damaging projects (*The Financial Times,* 8 August 2013). In this context the NPFG sold 23 palm oil companies because of environmental concerns (*The Financial Times,* 11 November 2013). According to Norway's State Secretary of Finance "[the NPFG] belongs to the people of Norway and it's important we manage the fund in a way that ensures broad support" (*The Financial Times*, 8 August 2013).

The international financial press watches closely divestment decisions based on ethical guidelines. Given the NPFG's massive size the implementation of ethical investment guidelines has real world implications. One observer highlights that "[as the NPFG] grows bigger, there is an increasing temptation to use it for non-investment goals"(*The Financial Times*, 3 Nov 2014). The NPFG has excluded firms that were associated with the production of anti-personnel land mines (e.g. Singapore Technologies Engineering, 26 April 2002), cluster munitions (e.g. Textron Inc., 31 December 2008), nuclear arms (e.g. Honeywell, 31 December 2005), tobacco (e.g. Philip Morris, 31 December 2009), severe environmental damage (e.g. Rio Tinto, 30 June 2008); serious violations of the rights of individuals in situation of war or conflict (e.g. Africa Israel Investments, 30 January 2014) (Regjeringen, 2015a).

Norway's Parliament (Storting) established the NPFG's regulatory framework with the Government Pension Fund Act. In parliamentary systems, such as Norway, the government can be dissolved at any time and therefore tends to be more responsive to population. The Pension Fund Act describes the NPFG's legal basis and structure. The Storting has entrusted the Ministry of Finance with the formal responsibility for the NPFG's management. The Finance Minister takes final decision of whether to exclude companies or industries (*The Financial Times* 11 Nov 2013). Clark and Monk statement that "[the NPFG] is not 'protected' from parliament and public opinion through statutory powers invested in its trustees" suggests that the NPFG is not a separate legal entity (Clark and Monk, 2009, p.2). The operational management is carried out by the Norges Bank – Norway's Central Bank (Regjeringen, 2015). In turn the Norges Bank is doing this through its asset management unit: Norges Bank Investment Management. Norges Bank's Executive Board is subject to supervision from the Parliament-appointed Supervisory Council, which also appoints the Bank's auditor.

*Australia's Future Fund The New Zealand Superannuation Fund and the Strategic Fund of Ireland*

The New Zealand Superannuation Fund (NZSF) shares a number of similarities with the NPFG. The New Zealand government uses the NZSF to save now in order to pay for the future cost of providing universal superannuation. As such the purpose of the NZSF is to reduce the tax burden on future taxpayers of the cost of New Zealand Superannuation. The NZSF is a long-term, growth-oriented global investment fund (NZSF, 2015). The NZSF invests initial Government contributions – and returns generated from these investments – internationally, in order to grow the size of the fund over the long term. With a portfolio of approximately US$ 20 bn the NZSF is one of New Zealand's largest institutional investors. The New Zealand Superannuation and Retirement Income Act 2001 establishes clear operational independence for the Guardians of the NZSF and establishes standards of public accountability. The Guardians are responsible for investing the funds and maximising return without undue risk to the NZSF as a whole and avoiding prejudice to New Zealand's reputation as a responsible member of the world community. The Guardians must maintain and operate the accounts in accordance with any directions given by the Minister or the Treasury (New Zealand Superannuation and Retirement Act 2001).

Like the NPFG the NZSF is characterised by high levels of transparency and the adoption of an ethical investment framework. Environmental and social standards are integrated in the NZSF investment decision-making process (NZSF, 2015a). The NZSF monitors the investment portfolio against best practice standards of the UN Global Conduct and the MSCI World Index. Companies outside this index are monitored individually. To date the NZSF excludes a number of sectors such as the tobacco industry, producers of cluster munitions, nuclear explosive devices and anti-personnel mines. Firms that have been excluded from the NZSF investment portfolio comprising Singapore Technologies Engineering Ltd, Honeywell, Africa-Israel Investments, Zijin Mining and Tokyo Electric (NZSF, 2015).

In a similar fashion, the Australian Future Fund (AFF) and the Ireland Strategic Investment Fund (ISIF) have adopted ethical investment guidelines. The ISIF was created in 2014 with the purpose to invest on a commercial basis in a manner designed to support economic activity in Ireland (ISIF, 2015). Thus far the Cluster Munitions and Anti-Personnel Mines Act 2008 are the only relevant legislation concerning ethical investments. (*Irish Times*, 13 August 2015). Any exclusion on the basis of ethical investment criteria has to be mandated by legislation (*Irish Times*, 13 August 2015). The AFF was established earlier in 2006 to meet unfunded superannuation liabilities. The AFF received its initial contributions from a combination of budget surpluses, and from the proceeds from the sale of the government's holding of Telstra – Australia's largest telecom/media company (AFF, 2015).

Like the NPFG and the NZSF the AFF excludes firms that are involved in the production of cluster munition, anti-personnel mines, and tobacco. In implementing these guidelines the AFF has excluded companies such as Singapore Technologies Engineering, Textron and British American Tobacco (AFF, 2015). Interestingly, the AFF and the ISIF have not excluded companies whose actions and omissions constitute unacceptable risks or severe environmental damage. Unlike the NPFG, the AFF has significant exposure to companies, such as Rio Tinto, that are banned by the NPFG.
That can be partly attributed to Australia's high exposure to the mining sector (*ABC News,* 20 November 2014). Similarly, Ireland's ISIF invests into companies, such as TransCanada, that have been controversial because of severe environmental concerns (*Irish Times*, 13 August 2015).

Both Ireland and Australia are parliamentary systems, which are characterized by high levels of political freedom. The AFF Board of Guardians is appointed by the Minister and is responsible for investing the assets of the AFF (AFF, 2015a). The AFF governance structure was designed in a way to increase its independence from domestic politics. Clark's statement that "the term of appointment of 5 years with the prospect of renewal was expected to severer the link with the short-term political cycle" highlights the government's attempt to protect AFF board members from political pressures (Clark, 2009, 19). Although the AFF ceded to popular public pressure in 2012 to sell out of tobacco and arms companies, it was highlighted that it will only sell out of coal assets only for financial reasons (The Sidney Morning Herald, 9 June 2015). Alone the AFF tobacco exposure was estimated to approximately AU $221 million. (ABC News 28 Feb 2013). The management function of ISIF is carried out by Irelands National Treasury Management Agency. Out of its nine members six are appointed by the Ministry of Finance for different time periods.

These findings suggest that SWFs from countries with parliamentary systems and high levels of political freedom tend to have adopted ethical investment guidelines. High levels of political freedom allow the unhindered expression of the wishes and dissatisfaction concerning SWF investments among the population. That in combination with regime type seems to be important in affecting the choices about the adaptation of ethical investment guidelines. In parliamentary systems governments are selected from an elected legislature, which can be dissolved at any time. This makes the Finance Minister especially responsive to population's wishes concerning SWF investments.

**3. SWFs without ethical investment frameworks**

*Alaska's Permanent Fund Chile's Economic and Social Stabilization Fund*

Unlike other OECD SWFs, the Alaska Permanent Fund (APF) has no specified ethical investment guidelines. In contrast to the NZSF and the NPFG, the APF has significant exposure to the tobacco industry (e.g. via its holdings in a number of tobacco firms such as British American Tobacco) as well as to the military/defence sector. For example, it holds significant shares in companies, notably Singapore Technologies Engineering, Rio Tinto and Honeywell, which are excluded from the investment portfolio of the NPFG and the NZSF (APF, 2015a).

The APF was established in 1976 in the context of Alaska's oil pipeline construction. Due to Alaska's high exposure to commodity price cycles the basic idea behind the creation of the APF was to save in good times and spend in bad times. However, the creation of the APF necessitated a constitutional amendment. Alaska's population broadly supported the constitutional amendment and the creation of the APF in a vote in 1976 (Brown and Thomas, 1994). The constitutional amendment stipulated that at "least 25 percent of all mineral lease rentals, royalties, royalty sales proceeds, federal mineral revenue-sharing payments and bonuses received by the state [should be placed with the APF]" (APF, 2015). To manage the investments of the APF the Alaska legislature established the APF corporation. As of 2015 the AUM of the APF were estimated at around US$ 50 bn.

High levels of political freedom in Alaska's political system within the US federal system are reflected in Alaska's economic policy making and the APF. According to Brown and Thomas (1994, p.44) this makes it very difficult to "promote any common goal on a long-term basis" with regard to the APF and Alaska's fiscal policy. Another factor relates to the APFs unique incentive structure. The APF's founding father Governor Hammond followed the idea of giving Alaska's residents a direct stake or interest in the APF by paying them an annual dividend out of its earnings (Brown and Thomas, 1994, p.41). That is an unusual practice among SWFs. Brown and Thomas' statement that the so-called APF dividend "soon became a sacred political cow" suggests that it is very risky for politicians to change the investment framework of the SWF (Brown and Thomas, 1994, p.43). The adoption of ethical investment guidelines can implies a tradeoff for the AFP's return. It is widely acknowledged that extensive exclusion based on ethical principles could harm the return and risk profile of funds (*The Financial Times* 3 Nov 2014).

Similar to the APF, Chile's Economic and Social Stabilization Fund (ESSF) has no specified ethical investment guidelines in place. The ESSF provides fiscal stabilization as it allows the financing of fiscal deficits. It reduces Chile's dependency on global business cycles and revenue volatility related to fluctuations in copper price and other sources. The ESSF was created in 2007 with an initial contribution of US$2.56 bn from Chile's old Copper Stabilization Fund (Hacienda, 2016). It receives on an annual basis the positive balance from Chile's fiscal surpluses after accounting for contributions for Chile's Pension Reserve Fund and payments of public debt (Hacienda, 2016). As of 2015 AUM of the ESSF were estimated at around US$ 15bn.

Under the Fiscal Responsibility Law the Finance Minister is responsible for deciding on the ESSF's investment policies. The Minister of Finance is appointed by the President. This gives the Minister a degree of insulation from popular demands. Interestingly there has been no public debate in Chile about the ESSF and ethical investment guidelines.[4] In turn the Finance Minister appointed the Central Bank as the agent responsible for the operational management of the ESSF. The Central Bank invests the ESSF resources in accordance with the instructions and restrictions established by the Minister of Finance. In defining the instructions and restrictions, the Finance Minister is supported by a Financial Committee, which provides advice on the aspects related to this decision.

In presidential systems the government is in office for a fixed term and the Minister of Finance is appointed by the President, which gives him a degree of insulation. That in turn provides more effective protection of the SWF from parliament and public opinion. This is reflected in the choices about the adoption of ethical investment guidelines. As a result, SWFs from countries with presidential systems tend to have no ethical investment guidelines.

*Singapore's Temasek and Malaysia's Khazanah Nasional,*

Singapore's Temasek is one of the most transparent SWFs in non-OECD countries.[5] Temasek was established in the mid 1970s as a private exempt company with a constitutional status. As of 2015 AUM of Temasek are estimated at nearly US$ 200bn. Temasek's investment spectrum covers a wide range of industries including energy, resources, technology and military. Although Temasek is among the most transparent SWFs critique about investments of Singapore's SWFs are only carried out in public to a very limited extent. The Law of Defamation constrains the right of free speech (Mauzy and Milne, 2002). The judicial system in Singapore has been regularly criticised for lack in independence, specifically in political sensitive areas.

Unlike other SWFs from countries with parliamentary systems Temasek's investments are not guided by a specified ethical framework. Singapore has been frequently described as an illiberal democracy or a non-liberal communitarian democracy with judicial actions applied to government criticism (see Mauzy and Milne, 2002). That is reflected in low levels of political freedom scores (see Freedomhouse, 2015). The People's Action Party has governed without interruption since Singapore independence in 1959 (Freedomhouse, 2015).

Like Singapore's Temasek, Malaysia's Khazanah Nasional has no explicated ethical investment guidelines. Its portfolio comprises some of Malaysia's largest and most important companies operating in different sectors including aviation, agriculture, food and technology (Khazanah, 2015).
Khazanah Nasional was created in 1993 with the aim of managing the transformation process of so-called government-linked companies — including flag-carrier Malaysia Airlines — into more commercially driven businesses (*The Financial Times* 14 Jan 2015). Khazanah is owned by the Minister of Finance Incorporated, a body attached to the Ministry of Finance. Although in the constitutional

[4] This observation was made by Kenneth Bunker an expert on economic policy in Chile.
[5] Temasek is one of Singapore's three state owned asset managers. The other two are the Government Investment Corporation of Singapore and the Monetary Authority of Singapore.

monarchy of Malaysia freedom of expression is constitutionally guaranteed it is restricted in practice (Freedhomhouse, 2015).

This is suggestive that SWFs from countries with parliamentary systems and low levels of political freedom tend to have no ethical investment guidelines. In parliamentary systems with low levels of political freedoms there is less political competition, which is again mirrored in the expression of popular whishes among a country's population. As a result the population is more hesitant to express its dissatisfaction and wishes concerning SWF investments. Due to less public conflict the governance structure of the SWF is more insulated. In turn this is mirrored in the choices about the adoption of ethical investment guidelines.

*The United Arab Emirates' Mubadala and the State Oil Fund of Azerbajian*

Similar to Singapore's Temasek and Malaysia's Khazannah, Abu Dhabi's Mubadala has no specified ethical guidelines in its investment framework. One of Mubadala's major strategic investment areas relates to the defense and advanced military maintenance sector. For example, Mubadala holds more than half of the shares of the Emirates Defence Industry Company – a leading defense manufacturing and military technology company (Mubadala, 2015). In addition, Mubadala partners with international corporations, such as Boing and Airbus (Mubadala, 2015a). Interestingly these companies have been excluded from the investment portfolio of the NPFG on grounds that refer to the production of weapons that may violate fundamental humanitarian principles (NBIM, 2015).

Mubadala official mandate refers to economic diversification and it invests actively in projects with long-term value potential, and that boost the creation of new industry and infrastructure in Abu Dhabi. Abu Dhabi is governed by a monarchy with strong rulers. Although the UAE provides for some freedom of expression, the government restricts this right in practice and it prohibits criticism of the government and as such its SWF (Freedomhouse, 2015).

Also the State Oil Fund of Azerbaijan (SOFAZ) has no investment guidelines explicated with regard to severe environmental damages, the production of nuclear arms and the tobacco industry. SOFAZ manages Azerbaijan's accumulated oil revenues with a purpose of developing and implementing projects of social-economic importance, notably in the infrastructure and energy sector such as the Heydar Aliyev Baku-Tbilisi-Ceyhan Main Export Pipeline (SOFAZ, 2015). SOFAZ is a legal entity separate from the government or central bank. SOFAZ's operation is guided by the constitution and presidential decrees (SOFAZ, 2015a). The president of Azerbaijan is the "supreme governing and reporting authority" for the SOFAZ (SOFAZ, 2015). The constitution of 1995 gives the President a strong power base with little accountability. President Aliyev's New Azerbaijan Party has dominated the political playing field since 1995. While the constitution guarantees freedom of the press, the authorities severely restrict the media in practice (Freedomhouse, 2015).

These findings suggest that SWFs from countries with presidential or monarchical systems and low levels of political freedom tend to have no ethical investment guidelines. In presidential systems with low levels of political freedom as well as in absolute monarchies the government/rulers are highly insulated from the wishes of the population. This combined with low levels of political freedom provides more effective protection of the SWF investments from legislature and public opinion. Again this is reflected in the choices about the adoption of ethical investment guidelines.

FINDINGS AND IMPLICATIONS

The article finds that mandate, funding source cannot account for variation with regard to the adoption of ethical investment guidelines among SWFs. It discovers substantial variation in terms of the adoption of ethical investment guidelines among the 10 most transparent SWFs. Variation occurs even among SWFs that belong to similar country groupings (i.e. within OECD countries). For example, both Alaska as well as Norway have oil funded SWFs with a stabilisation and future savings mandates but both differ in terms of ethical investment guidelines. Norway's NPFG adopted ethical investment guidelines, whereas Alaska's AFF did not (see Table 2).

*Table 2, Most transparent SWFs, ethical guidelines, political freedom and regime type.*

| **Country** | **SWF name** | **Ethical guidelines specified** | **Political Freedom (Freedomhouse)** | **Regime type** |
|---|---|---|---|---|
| Norway | Government Pension Fund | **Yes** | **1** | **Parliamentary system*** |
| US-Alaska | Permanent Fund | **No** | **1** | **Presidential republic** |
| New Zealand | New Zealand Superannuation Fund | **Yes** | **1** | **Parliamentary system*** |
| Ireland | National Pension Reserve Fund | **Yes** | **1** | **Parliamentary system** |
| Australia | Future Fund | **Yes** | **1** | **Parliamentary system*** |
| Singapore | Temasek | **No** | **4** | **Parliamentary system** |
| United Arab Emirates | Mubadala | **No** | **6** | **Absolute Monarchy** |
| Azerbaijan | State Oil Fund | **No** | **6** | **Presidential system** |
| Chile | Social and Economic Stabilization Fund | **No** | **1** | **Presidential system** |
| Malaysia | Khazanah Nasional | **No** | **4** | **Parliamentary system** |

**Sources:** Data compiled by the author from SWF Institute (2015), Freedomhouse (2015).

* Constitutional monarchy or commonwealth elements.

1=best, 7=worst: 1 free, 4 partly free, 6 not free

SWFs of countries with low political freedom scores are less likely to adopt ethical investment guidelines. That is because the political structures in place provide the SWF governance structure with more insulation from public opinion and from the values of their citizens. In line with this observation this article finds that countries with high levels of political freedom are more likely to have SWF with explicated ethical investment guidelines. Here governments and the political system in place giving greater affect to the values of their citizens through the SWFs investment policies.

Data reveals fine-grained differences among countries with high political freedom scores. Interestingly all of the SWFs from countries with parliamentary systems and high levels of political freedom have adopted an ethical investment framework (see Table 3). In parliamentary systems governments can be dissolved at any time and therefore it is more responsive to its population. In presidential systems the government is in office for a fixed term and the Minister of Finance is appointed by the President, which gives him a degree of insulation. This provides more effective protection of the SWF from parliament and public opinion. That is reflected in the choices about the adoption of ethical investment guidelines. SWFs from countries with presidential systems tend to have no ethical investment guidelines. Based on these findings we are able to formulate an initial hypothesis: SWFs of countries with parliamentary systems and high levels of political freedom are more likely to adopt ethical investment guidelines.

*Table 3, Most transparent SWFs/Countries, Political Systems and Level of Political Freedom*

| | | **Political freedom** | |
|---|---|---|---|
| | | *Low* | *high* |
| **Political system** | *Parliamentary* | Temasek (Singapore) | NPFG (Norway)<br>AFF (Australia)<br>NZSF (New Zealand)<br>ISIF (Ireland) |
| | *Presid* | SOFAZ (Azerbaijan) | APF (Alaska)<br>ESSF (Chile) |
| | *Monarchy* | Mubadala (Abu Dhabi) Khazanah (Malaysia) | n.a. |

The adaptation of ethical investment principles among SWFs should not alarm policy makers, and investors but it raises a number of policy relevant issues. In the current debate, SWFs of non-democratic countries are frequently associated with political driven motives. The investment activities of SWFs, and as such also their ethical investment activities, have been extensively covered and monitored by observers, most notably Bloomberg and Reuters, and think tanks, such as the Sovereign

Wealth Fund Institute, and the financial press. The increase in private financial monitoring was accompanied by an increase in public 'political' monitoring. Major Western economies, such as the US Germany and France, have introduced new or updated existing regulatory frameworks aimed at monitoring SWF investments (see Thatcher 2012). However, all of the SWFs which have applied over the recent years – ethical – non economic investment principles coming from Western democratic countries. To understand the adaptation of ethical investment guidelines more focus has to be put on the link between regime type and levels of transparency.

## CONCLUSION

This article has started with the puzzle of variation in ethical investment guidelines among sovereign wealth funds. It investigated the link between regime type and the adoption of ethical investment frameworks among SWFs. It compared the adaptation of ethical guidelines among the most transparent SWFs and linked variation to regime type and scores of political freedom. The basic observation was that SWFs of countries with high political freedom scores were more likely to have ethical investment frameworks. But fine-grained differences occur between parliamentary and presidential systems. SWFs from countries with parliamentary systems and high levels of political freedom tend to have ethical investment guidelines, whereas SWFs from countries with presidential systems and high levels of political freedom tend to have no ethical investment guidelines. However, the initial observations and hypothesis developed needs further testing in terms of causal mechanisms.

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